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SESSION V

DEVELOPING MEDIUM AND LONG-TERM CORPORATE BONDS

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Developing Medium & Long-Term Corporate Bonds.

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Introduction:

A Corporation is a Limited Liability Company which is a legal (or juristic) person. Company laws in every Country bestow on such person many of the traits of human being's such as name, nationality and most importantly the capacity to contract, bear debt and litigate, via a council, in the court of law. While very little has been written on the Shari'ah aspects of the concept of legal person, contemporary Shari'ah scholars appear to agree to the concept and approve of the model of public limited liability company and of shares as an evidence of partnership. However, such agreement doesn't go beyond ordinary shares.

Other types of securities and means through which modern corporations acquire finance, either not dealt with or rendered to be not permissible. Moreover, the fact that the concept of legal person is now accepted by the Shari'ah scholars is immensely significant. It opens tremendous opportunities for financial innovations within the framework of Shari'ah. This is because it is possible for a corporation to be party to all the nominate contracts in Shari'ah, including Mudarabah, Musharakah, Murabaha and Salam.

These contracts are, essentially, financial ones and had been used for the purpose of financing investment.

In this paper we will attempt to examine possible structures that can produce what may be termed "corporate bonds" within the limits of Shari'ah.

Medium and Long Term bonds in conventional corporate finances:

Bonds are very old. Perhaps the first "bond" was the Grand Parti of Francis I in 1555 (J. Walmsley p.3) Firms also issued bonds from an early date. The Dutch East India Co. has bonds outstanding in the seventeenth century (Franklin Allen p.12).

A bond is a debt security. Classical bonds bear a fixed rate of interest and matures on a date fixed at time of issue. However, there are many "hybrid" bonds. Some of them are convertible into common stock (at a specified price) some come with equity warranty, zero coupon....etc.

The capital structure of modern corporations includes both debt and equity. In most cases, debt plays an important rule in corporate finance in conventional companies. This because, in general, debt is "less expensive" than equity. Further, share holders can retain control over their company in the case of finance via debt compared to equity. A Company can borrow from banks and it can also borrow from the public through the issuance of bonds which can be floated in an organized market.

It is, therefore, important to clarify Shari'ah position on the rule of debt in corporate finance. Certainly, debt is not prohibited in Shari'ah. Permissible Shari'ah contracts such as differed payment sale, Murabaha, Salam all creates debt. However, these are all sale transaction involving the procurement of goods and services. In such cases, even "time value of money" can be considered. It is another thing when it comes to borrowing.

In modern finance such transaction always involves interest, and hence is not permissible from Shari'ah point of view. This, however, doesn't mean that the door of debt finance is closed to an Islamic corporation. It is only the door of securitized monetary debt. In the present paper we will survey the

alternatives available to a corporation that is keen to abide by the rules of Shari'ah and yet issue bonds. Almost all the ideas presented are new and not tried. They are introduced for purpose of discussion.

A- An Islamically acceptable model of Preference shares:

i) What is a preference share:

A preference share is a security the holder of which is entitled to a preferential right over holders of ordinary shares of the issuing company. Typically, a preferred shareholder is promised a fixed cash payment every period and a fixed redemption value for his shares upon firm's liquidation. Such fixed payment may be commultative, or it may be payable only out of the profits of each year. Furthermore, preference shares generally have no voting power.

Preference shares are considered an equity security and not debt for two reasons (William Megginson p. 400)

a) Their rights to preferred dividend payment is not legally-enforceable claim the way that bond coupons payment is, but must be approved by firm's board of directors each period. Their only right is that they are paid before common stock holders receive cash dividend and to be paid the face value of this claim before any money is distributed to common stock holders upon liquidation.

b) Preferred stock are perpetual security. It has no fixed maturity. In some cases they are structured to be convertible to common stock a holder or issuer discretion. A debt security, always, has a maturity.

ii) History of Preference shares:

Debt securities may be the oldest negotiable financial instrument, and for a long time the only one. Financing through the issuance of debt was done, for centuries, by corporations and semi corporational corporations. Some writers trace preference shares to the 16th century, (Franklin Allen p.12) which means that they came even before ordinary shares.

Preference shares, however, became so important in the financial structure of public companies after the 1840's in England. They came partially, as a response to corporation restrictions on debt to equity ratio. (A history of corporate finance p. 152). Loans were not allowed to exceed for public companies, for public companies, one third of share capital. It provided a means to raise additional capital to complete construction of financially trampled canals and railroads.

iii) Why preference shares:

Even today, preference shares make a lot since as part of corporate capital structure for many reasons.

1- It provides a means to raise additional capital to the company without diluting equity of the original owners.

2- Although preference shares has many of the features of debt securities (non-voting, face value redemption, fixed return), holders of preference share can't force the company into receivership, because they remain equity not debt.

3- Preference shares become even more important for venture capital investment. As we know venture capital is the force driving developed economies today. In Europe, the size of venture capital investment exceeded $ 20 billion in 1998 alone. In most cases, this goes to financing new innovation in technology, medicine, electronics... etc. sizeable amounts of capital is needed before an innovative startup company can go to the stage of IPO.

In this context venture capital funds are needed, either directly or though specialized investment funds. In both cases there is moral hazard and adverse selection included in the relationship between fund providers, who do not participate in the day to do management and owner-investor who is directly involved in the development process. Because start-up companies are not as transparent as mature publicly traded corporations, the fund provide faces the risk of losing all his investment in the event that company is liquidated before IPO.

Venture capital firms try to structure the deal so that management only benefits if the firm succeeded. In this case providing funds on the basis of preference shares protect their interest. Hence, venture capitalist usually buy preferred stock convertible into common shares when the company goes public, and then will have prior claim on the assets of the firm in case of liquidation. (sahlman, W.A p. 23-36).

A model of Islamically acceptable preference shares:

A company can issue preference shares within the Shari'ah permissibility in the following form:

a) The issue is based on the Mudarabah contract. The issuing company is the *Mudarib* and the holders are *Rab-ul-mal*. Contemporary scholars do allow the "legal person" to be a party to a Mudarabah contract. They also permit the Mudarabah to be in the form of certificates (or in this case shares).

b) These shares can be redeemable at par value at some time in the future. Such time can be specified in the terms of issue. It can also be left to be decided at the discretion of the company. The issuing company may not digress from the face value redemption obligation, except where it can be shown that the capital collected through the issuance of such shares was actually reduced due to losses which were not due to the negligence of mis-conduct of the Mudarib (i.e. the management of the company).

In case of liquidation, holders of such share have a preference status over holders of ordinary shares. This is because their fund constitutes an obligation on the company which has to disperse of before it can pay anything to ordinary share holders.

c) The issuing company may not guarantee a fixed income to the holders of these shares. However, they get their share of profit in a ratio that need not be equal to the holders of ordinary shares.

d) Furthermore, such profit, once realized, becomes an obligation on the company and can't be used to, for example, pay back creditors of the company. Hence,

holders of such shares will effectively have a preference status vis-à-vis profit compared to ordinary share holders. Their profit can also be commullative if profit was declared but not distributed.

Structuring Mudarabah in the form of certificates.

Mudaraba as contract of partnership is very old. At times, like the Middle Ages, it was the core of the investment, activities in most Muslim societies.

Mudaraba remains a very important form of contract in the working of Islamic banks. Developing structures which include Mudarabah in the form of marketable securities do not change the nature of the Mudaraba contract nor violate the basic Shari'ah requirement for such contract.

The Islamic jurisprudence Academy of the OIC resolved in its fourth conference (1408 H) about the subject, which permitted issuing Mudaraba based negotiable certificate.

B- Musharakah Certificates.

It is also possible for a corporation to issue Musharakah based certificates. Such instruments is not unlike that based on Mudarabah, except certain aspect doing with the status of the holder vis ordinary share holders.

a) Guidelines will be incorporated into the Musharakah agreement which will focus on discouraging the entity from indulging in activities that may adversely effect profitability. These mutually agreed upon guidelines will be structured so that they are flexible and can be relaxed or altered, should change in the business environment warrant as such.

b) At the time of finalizing the terms and conditions for profit sharing, factors such as depreciation, amortization and other income shall be taken into account because these are dependent on the nature of operations and various types of financial transactions. Moreover, other income may have to be given a specific treatment. All these factors are to be examined carefully before profit sharing ratio is agreed upon.

c) An enhanced / significant role for Religious Board, Rating Agency, Trustees and Company Auditors is envisaged in the implementation of the model.

d) Primarily the model aims at targeting Musharakah Investment in listed companies.

e) Most important feature is that the entity reserves would be available to set of future losses. If any. Accumulated reserves are the ownership of the current holders of the company's ordinary shares. Because the decision to issue these Musharakah certificates is taken at the level of share holders assembly, it constitutes an approval of the current owners of the company to share reserves with these certificate holders.

For the potential investors, the existence of large reserves at the time of issue of certificates gives assurances that the company will be able to distribute profit in the years to come.

<u>Redemption of Musharakah Investment</u>

a) Musharakah investment can be redeemed in piece meal or in lump sum.

b) *Before maturity* the Investor can redeem his Musharakah Investment in the open market, by selling his certificates.

c) *On maturity* certificate holder will share in any appreciation in the issuer's assets that takes place during the term of the Musharakah investment. The sharing of this appreciation may be determined either by entity's share price in the market (one year moving average prices) or book value of the entity's share. The valuation shall be done at the time of entering into and completion of the tenor of Musharakah investment. The difference of the two, will become the basis of maximum admissible sharing of the appreciation in the entity's asset (assuming valuation at the maturity is higher).

d) At the time of initial Musharakah agreement, the parties may mutually agree to a ratio for sharing any appreciation in the entity's asset base. But in the case of depreciation, which would be the situation if entity suffers a loss more than the reserves built up from past profits and there is also a fall in the share price in the stock exchange market, it would be shared strictly in ratio of funds deployed on profit sharing basis. This is in line with the Musharakah jurisprudence where profit may be shared non-prorata while loss must be.

<u>Delay in payment of profit / redemption of Musharakah Investment.</u>

a) Investors will have the option to extend the *duration* of Musharakah Investment in case an entity incurs a loss. However, should investors decide for redemption of their investment and the entity is unable to fulfil its obligation, then the Musharakah investment shall rank Pari Passu with shareholders capital.

b) In case profit was made but not distributed then the 'due profit' / "due amount not redeemed" will be treated as new Musharakah Investment and will be considered as being a contributing capital element to an entity's profit until such time it is paid off.

c) Where a loss incurring entity may not foresee better future prospects the Musharakah capital amount will rank Pari Passu with shareholder's paid-up capital but the profit payments due during or at the end of the tenor but not paid would become senior debt with charge ranked Pari Passu with first charge holders on the assets.

d- If certificates are traded in an organized market and they are negotiable, then such negotiability must be conditional by the requirement of sale in Shari'ah.

C- The Salam Instrument.

Sometimes the corporation is in need of cash. Conventionally it can borrow from banks or issue bonds. It is possible for such corporation to get Funds on the basis of Salam contract.

<u>What is *Salam*?</u>

Salam is a sale contract. Unlike standard sale contracts, the price is paid at the time of contracting while the sold goods are delivered at a future date. *Salam* is therefore, a forward contract. However, its different from the standard commodity forward contracts that are known in commodity markets as will be seen below.

Salam was known at the time of the prophet (PBUH). It was always looked at as a "means of finance." This is because

farmers use it to procure the seeds and fertilizers by selling their future harvest at the time of planting. *Salam* based transactions, however, are not confined to wheat and barley and the rest of the agricultural products. Rather it can be used for any fungible[1] goods. This is because the seller in *Salam* is not allowed to sell a "particular" good or one from a "particular" source. He sells a "well-described" standard one.

Because it is intended to be a "mode of finance" not a means of speculation, it is a requirement, for validity of *Salam,* to pay the whole price at the time of contracting. *Salam*, though it had been neglected for too long by contemporary economists, offers, in our view a tremendous potential.

We believe that *Salam* can be piloted into a *Shari'ah* substitute for conventional debt instruments.

A *Salam* based financial Instrument:

When an Islamic corporation (or any economic agent) needs money to acquire goods, they can buy them through Murabaha. If they need funds to expand capacity or increase market share and they need cash, they can use Salam.

This instrument we are suggesting can be structured as follows:

a) The corporation which needs for example 500 million dinar, can issue *Salam* certificates equaling that amount, with small denominations, say 100 dinar each.

b) Each certificate represent a *Salam* contract, the seller is the corporation and the buyer is the holder of that certificate who paid its nominal value.

c) Each certificate promises that at maturity, (one year for example), the corporation will deliver to the

holder a specified quantity (1/2 ton) of the underlying commodity, which is described fully on the back of the certificate[1], or in a prospectus.

d) Once the corporation receives the cash, (via a process similar to bond floating) it can use it for any purpose, including short term deficit financing.

e) At maturity, the issuer will be due to deliver the sold goods in kind. For this purpose the corporation will, certainly, buy from the open market and deliver to the certificate holder. If the corporation produces the underlying commodity it is not permissible to put a condition in the contract that the sold good will be from corporation production except in cases where a large number of production facilities are owned by the corporation.

Goods suitable for this instrument:

There is some restrictions in *Shari'ah*, on the kind of goods that can be an object of *Salam*. They can only be fungible-like commodities. This is what is called in *Shari'ah* "Mithly".

A Mithly, is a good who is standardized into substitutable or identical units, and whose utility can only be derived through consumption or the changing of its basic form. It is the type of product which has no important characteristics that identify it as coming from a particular supplier. Wheat, rice, barley and other grains are of this type. Oil, iron, copper are also "mithlys". A building, an aircraft, an automobile and power generator are not mithlys, and hence can not be subjects of *Salam*. However, electricity measured in kilowatt could be considered a mithly. Seats in air flights can also be mithly's.

Payments of price in *Salam*:

Salam may look like regular forward contract. Forward contracts however represent agreements between buyers and sellers to deliver something in the future. No payment is made but only a settlement on the agreed date. However, *Salam* is not permissible without the full payment of price at the time of contracting. Delay (over 3 days), partial payment or advances in the form of anything other than money (like letters of guarantee....etc.) but money casts the contract null and void from *Shari'ah* point of view.

In our example, as the corporation flouts these *Salam* certificates (each of which represents a *Salam* contract), it is a *Shari'ah* requirement that it receives immediately the face value of each certificate in cash. This is a plus point for this instrument.

Liquidity:

The above mentioned structure is within the "standard" *Salam* contract, i.e. one that almost all *Shari'ah* scholars will agree on. In that so-called standard *Salam* contract, the purchased goods are not supposed to be sold before actual possesment at maturity. Prior to delivery, certificate holder is not allowed to dispose of his certificate by sale for this purports to selling the underlying commodity before actual possession. Certainly this renders our *Salam* instrument impracticable. This is because, liquidity is one of the most important aspect of short-term investment, second only to profitability. A money market instrument that is not negotiable will not be very useful.

Is it possible, from *Shari'ah* point of view, to introduce "negotiability" into the *Salam* certificate? This is our main contribution to the subject.

In other words allowing the certificate holder to sell his certificate before maturity? If this can be done it means that an

investor will buy such certificate if he expect prices of the underlying commodity to he higher at maturity. But if his exceptions changes before that date he can unload his investment and dispose of his certificate. Furthermore, when an investor knows that resale is possible at any time before maturity through an organized market, more and more people will invest in this instrument and subscribe in this venture.

It is quite clear, from contractual point of view, that sale of *Salam* certificate, is actually a sale of the underlying good or commodity. This is because as one exchanges such certificates for money, he is actually giving the buyer the right to receive, at maturity, the specified amount of that good. Hence, negotiability, to be acceptable from *Shari'ah* point of view, needs a proof that *Shari'ah* does allow sale of the *Salam* goods before this actual receipt. The standard jurisprudence rule is that such thing is not permissible. Never the less we present in an appendix to this paper that the Maliki school clearly stands opposite to this stand allowing such sale. This is the only deviation we are taking away from the standard model of *Salam* in *Shari'ah*.

Guidelines and Restrictions:

Sale of the non-food *Salam* goods before actual possession is permitted in the Maliki school. All four schools of *figh* are correct and acceptable. However, with introduction of the following conditions and guidelines, we are actually placing our model even with the span of permissibility which extends to more than just Maliki School. These guidelines are as follows:

1- That the *Salam* goods are not food or food stuffs, because this contradicts an authentic narration from the prophet (PBUH), which made it a requirement that food is only sold after being in the actual possession of the seller. Commodities other than food can be sold before actual

possession. These commodities like iron, copper & petroleum.... etc.

2- That the corporation (issuer) never buys-back, at profit (i.e. paying more than the face value of the certificate), *Salam* certificates. In our scheme of *Salam* certificates, the corporation is selling a commodity on *Salam* basis. It is required, therefore, to actually deliver, at maturity, the quantity of the sold good.

   Throughout the duration of the *Salam* contract, there is a lender-borrower relationship between the corporation and the holder of the certificate. If issuer buys back the certificate, this, from contractual standpoint means that the corporation is actually selling its obligation (debt) to the creditor. This is not impermissible in *Shari'ah*. It is a *Shari'ah* requirement however that it is sold at par value (face value of the certificate) or at a lower value, but not at profit. It is possible, furthermore, for the corporation to that needs to dispose of the contract before maturity to liquidate its position through parallel *Salam* an idea which needs to be further investigated.

3- The issuer must be a bonafide *Salam* seller and does not deal only in monetary debts:

   This means that the corporation must be ready to deliver the sold goods to all the holders of these certificates at maturity. This scheme must include stringent conditions and penalties on the corporation if more certificates are issued than corporation's ability to deliver. Certainly the corporation can sell its own production on Salam basis.

   This may be an important difference between *Salam* certificates and conventional bonds i.e. having a self restraining mechanism that forbids the corporation from over issuance of these debt instrument. Certainly the corporation can always buy from the open market at maturity and deliver to holder. However, there has to be

some automatic penalties if corporation over-issue these certificates.

Operationlization of these checks is not easy, one possibility could be in form of automatic increase in the value of the certificate over and above the market price of the underlying asset. Without such mechanism, the corporation obligation will be inflated way beyond its ability to deliver which will make the whole scheme a failure since it will end-up a conventional debt instrument.

Clearly our suggestion of penalty goes against the basic *Shari'ah* rule of *Salam*. It is not permitted that the seller, in case of failure to deliver, compensate the creditor for any thing above the nominal value. But if this is not adopted, it will create an incentive on the part of corporation to always fail to deliver. This penalty is essential to the successful operation of the scheme.

On the other hand, an amount over and above the nominal value is *riba*. To mitigate this two possible solution may be adopted:

- The amount, though is higher in value, is paid in different commodity but not in money.

- The amount over and above the nominal value is clearly distinguished and paid to a charity. It will not be very effective if this is done by the corporation. Hence the scheme should include mechanisms to effectively enforce this.

4- The commodities which are subject of this instrument ought to be internationally traded goods. This is not a *Shari'ah* requirement but it is a restriction introduced to make sure that no exploitation is exercised by any of the parties involved through manipulation of prices. This will

not be difficult because the eligible goods for *Salam* contracts are only fungibles. The price of these goods is international by nature. Except in closed economics, the world price of oil, steel, aluminum imposes itself on the local markets. This will introduce the organizational aspect of the market and the flow of information about expected prices in the future which are very important in this regard.

Holders appoint an agent to sell their goods:

Like any other market, investors (unlike consumers) are interested in profit not in the actual delivery of the underlying commodities. Although this profit has, for *Shari'ah* purpose, to be generated from genuine commercial transaction via the purchase and resale of a commodity, there is nothing in *Shari'ah* that requires the buyer himself to exercise the sale of these goods. This scheme will be more successful and a whole lot more efficient, if a general agent is appointed to receive, on behalf of all or some holders of these certificates, delivery from the corporation and sell, for the benefit of these holders, in the open market at going prices. This agent may charge a percentage of the nominal value of each certificate. This agent (or agents) can also take care of channeling the amount which is due from penalties to charitable purposes which was mentioned above.

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